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STATE OF MONTANA

INSURANCE DEPARTMENT
and
INSURANCE COMMISSIONER

Report on the Need for State Regulation
of the Insurance Industry

1978

A SUNSET PERFORMANCE REVIEW



STATE OF MONTANA

Office of the Legislative Auditor

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July 28, 1978

The Legislative Audit Committee
of the Montana State Legislature:

Herein transmitted is our sunset performance audit of the Montana Insurance Department and Insurance Commissioner. The audit was conducted in response to the 1977 sunset law, which terminates the department on July 1, 1979. The intent of the audit was to determine the need for state regulation of Montana's insurance industry.

The audit focused upon the six questions of the sunset law and includes an examination of department operations. It does not encompass a review of the department's financial transactions or overall compliance with state laws.

There are no formal recommendations in the report since the responsibility for such recommendations lies with the Legislative Audit Committee. Nevertheless, we discussed the contents of the report with the Insurance Commissioner, Deputy Commissioner and other members of the Insurance Department staff.

We wish to express our appreciation to the Commissioner of Insurance and the Insurance Department staff for the assistance they provided during the audit. We also wish to thank members of the insurance industry throughout the state for the assistance they gave us.

Respectfully submitted,

Morris L. Bruset, C.P.A.
Legislative Auditor

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ELECTIVE AND ADMINISTRATIVE OFFICIALS

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State Auditor,
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Office of the Legislative Auditor

SUNSET PERFORMANCE AUDIT OF THE
OFFICE OF COMMISSIONER OF INSURANCE
AND THE INSURANCE DEPARTMENT

SUMMARY

Montana's 1977 Legislature passed Senate Bill 162 as Chapter 562, Laws of Montana, 1977. The law, commonly referred to as the "sunset law," terminates numerous regulatory boards and agencies and specifically calls for a performance audit of each agency prior to scheduled termination. The sunset law terminates the Department of Insurance on July 1, 1979. This performance audit is in response to the legal requirement for review of the board prior to termination.

Chapter I (page 1) introduces the report by explaining the objectives and intent of sunset legislation, the six questions which relate to the need for state regulation and activities of the state directed toward meeting that need, and the scope of our audit.

Chapter II (page 5) provides a background on the evolution of the insurance industry by tracing its earliest beginnings to insurance in the United States and then to Montana specifically. This chapter also presents the Insurance Department's organization and funding (page 8). Lastly, the department operations (page 10) are described. The operations are company supervision, agent supervision, policyholder's service section, and policy forms and rates.

Chapter III (page 26) addresses the need for regulating the insurance industry in Montana and the harm which could result

from deregulation. Two questions are answered--(1) Would the absence of regulation significantly harm and endanger the public's health, safety, or welfare; and (2) Is there a reasonable relationship between the exercise of the state's police power and the protection of the public's health, safety, and welfare?

In answer to the first question (page 30), we conclude that sufficient historical evidence exists to say that the absence of regulation in the insurance industry could significantly endanger the public's health, safety, and welfare.

The second question relates to whether the current activities are sufficient to protect the public from potential harm addressed in the first question. To answer this question we evaluated the department's current regulation of the insurance industry in Montana (page 33). The evaluation disclosed instances where the department was not complying with certain laws. In addition, problems were noted with the present methods of regulating insurance companies and agents.

Based upon our findings, we concluded that certain improvements in the regulatory process could be made to more reasonably protect the public (page 55).

Chapter IV (page 57) addresses a single question--Are all facets of the regulatory process designed solely for the purpose of, and have as their primary effect, the protection of the public? This chapter considers the possibility that some areas of present regulation may be insufficient to adequately protect the public. Insurance consumers' accessibility to the department

is questioned as well as the present extent of policy disclosure in life insurance sales (page 58). The need for agent trust accounts and more definitive regulations of health service corporations and title insurers is discussed (page 62). Departmental staffing is considered (page 65) and the need for a formal training program is stated. The chapter concludes that certain facets of the regulatory process could be designed for additional protection of the public.

Chapter V (page 70) considers two questions--Does the regulation have the effect of directly or indirectly increasing the cost of goods or services; and, Is the increase in cost more harmful to the public than the harm which could result from the absence of regulation? The costs of insurance regulation definitely add to the costs of insurance and these costs must be eventually paid by the consumer (page 71). From a historical perspective, the absence of regulation would generate social and economic costs far in excess of the present costs of regulation (page 72).

Chapter VI (page 73) addresses the sixth and final question--Is there another less restrictive method of regulation available which could adequately protect the public? The report discusses the present form of regulation used in Montana and other less restrictive alternatives which are available, including no regulation. Included are three tables designed to aid the Legislative Audit Committee in recommending the regulatory alternative most appropriate for Montana, and alternative regulatory facets under

each form of regulation (pages 78, 79, 80). Additionally, a supplement to all sunset reviews has been prepared for a more in-depth discussion of the regulatory alternatives in Chapter VI.

Chapter I

INTRODUCTION

This sunset performance audit addresses the need for state regulation of the insurance industry by the Commissioner of Insurance and the Insurance Department,¹ State Auditor's Office. The Commissioner of Insurance and the Insurance Department (hereinafter referred to as the department) have the responsibility to protect the insurance buying public of Montana. In providing this protection, the department must maintain fairness in insurance transactions, monitor solvency of insurers, determine the adequacy of insurance markets, and encourage competition between insurers on a sound financial basis.

REPORT OBJECTIVES

The 1977 Legislature passed a law terminating numerous regulatory boards and agencies, including the position of Commissioner of Insurance and the Insurance Department.² This law, commonly referred to as the "sunset law," requires the Legislative Audit Committee to conduct a performance audit of each terminated agency. The performance audit must review the need for each department/agency and the Legislative Audit Committee must offer recommendations for reestablishment, modification, or termination of the department/agency in question.

¹ The Insurance Department was created as a regulatory unit of the State Auditor's Office. The organizational structure of the State Auditor's Office was not subject to the 1971 Executive Reorganization standard terminology. The Insurance Department is known as a "department" although it is not one of the 19 departments created pursuant to the 1971 Reorganization Act.

² Title 82, Chapter 46, R.C.M. 1947.

In defining legislative intent, the sunset law states that, by requiring periodic evaluation in the form of a performance audit, the legislature will be in a better position to ensure that agencies and programs exist only to be responsive to state citizens' needs. The sunset law terminates the department on July 1, 1979. This sunset performance audit is in response to the legal requirement for review prior to department termination.

REPORT ORGANIZATION

The sunset law requires the thorough examination of the following questions during the conduct of the performance audit:

"(a) Would the absence of regulation significantly harm or endanger the public health, safety, or welfare?

(b) Is there a reasonable relationship between the exercise of the state's police power and the protection of the public health, safety, or welfare?

(c) Is there another less restrictive method of regulation available which could adequately protect the public?

(d) Does the regulation have the effect of directly or indirectly increasing the costs of any goods or services involved and, if so, to what degree?

(e) Is the increase in cost more harmful to the public than the harm which could result from the absence of regulation?

(f) Are all facets of the regulatory process designed solely for the purpose of, and have as their primary effect, the protection of the public?"¹

Chapter I is introductory. It summarizes the objectives, organization, and scope of this report.

Chapter II presents background information on the evolution of the insurance industry. Included in this background information is a discussion of the historical significance of insurance in the world, the United States, and Montana. Chapter II concludes

¹ Senate Bill 162, enrolled as Chapter 562, Laws of Montana, 1977, and codified as Title 82, Chapter 46, R.C.M. 1947.

with a discussion of the department's organization, staffing, funding, specific goals and corresponding functions.

Chapter III addresses two of the questions posed in the sunset law. The first question asks if the absence of regulation would significantly harm or endanger the public's health, safety, or welfare. To answer this question we analyze the extent to which the public depends upon the current regulation of the insurance industry and its product.

The second question addressed in Chapter III asks if there is a reasonable relationship between the exercise of the state's police power and the protection of the public's health, safety, or welfare. To analyze and address this question, we review Montana's insurance regulation law and discuss the current performance of the department.

Chapter IV addresses another question posed by the sunset law: Whether all facets of the regulatory process are designed solely for the public's protection. To analyze this question we review the various laws, rules, and regulations under which the department currently operates.

Chapter V addresses two additional questions of the sunset law. That is, whether state regulation of the insurance industry has the effect of directly or indirectly increasing the costs to the public and whether such an increase is more harmful than the harm which could result from the absence of regulation.

Chapter VI presents alternative methods of regulating the insurance industry in Montana.

SCOPE OF THE AUDIT

This performance audit primarily addresses the need for state regulation of the insurance industry. It focuses upon the six questions posed in the sunset law and includes an examination into the effectiveness of the operations of the department. It does not encompass a review of the financial transactions of the department or the department's compliance with all state laws.

CHAPTER II

BACKGROUND

EARLIEST TRACES OF INSURANCE

The earliest traces of insurance extend back to the early Egyptians, Chinese, and Hindus, and insurance is known to have been used among the Greeks as early as the third century B.C. Early insurance took the form of benevolent societies organized primarily for social and religious purposes. Societies extended aid to their unfortunate members from a fund contributed to by all.

The first evidence that we have of any extensive use of the contract of insurance is found in the history and records of merchants of the Italian cities in the early Middle Ages. The Italian practice of insuring commercial ventures against disaster rapidly extended to other maritime states of Europe. "The Lombard merchants who came to London in the thirteenth century brought with them the custom of insuring against the hazards of trade. . . . The earliest known policy form was written in Genoa in 1347 and a statutory form was prescribed in Florence in 1523. It was not until the middle of the eighteenth century that the common-law courts began to take adequate cognizance of insurance causes."¹

DEVELOPMENT OF INSURANCE IN THE UNITED STATES

In 1725 the first fire insurance company was established in the American Colonies and was known as the "Philadelphia Contributionship for Insuring Houses from Loss by Fire," Benjamin Franklin being one of its directors.

¹Vance on Insurance, William R. Vance, West Publishing.

In 1759 the first effort was made to establish life insurance in the United States. A mutual benefit association of Presbyterian ministers was chartered in the colony of Pennsylvania. Similar small mutual companies were formed during the latter part of the eighteenth century and the first part of the nineteenth century. The development of accident insurance dates from shortly after 1860. The first such policies were designed to protect those traveling by railroad, which was then regarded as a rather hazardous undertaking.

DEVELOPMENT OF INSURANCE REGULATION

Under the 1789 United States Constitution, the Federal Congress was granted the power "to regulate commerce with foreign nations, and among the several states . . ." (U.S. Constitution, Art. I, Sec. 8(3).) State regulation of insurance began as early as 1810. State regulation was applied to transactions occurring across state lines but Congress did not try to regulate these transactions.

In the 1869 United States Supreme Court decision of Paul v. Virginia,¹ the court ruled that insurance was not commerce and was not subject to the interstate commerce clause of the United States Constitution. By upholding a Virginia state law which subjected out-of-state insurance companies and their local agents to a state licensing requirement, insurance companies were considered exempt from the federal antitrust laws. The states' exclusive domain over the regulation of insurance was upheld.

¹ Paul vs. Virginia, 8 Wall 168 (1869).

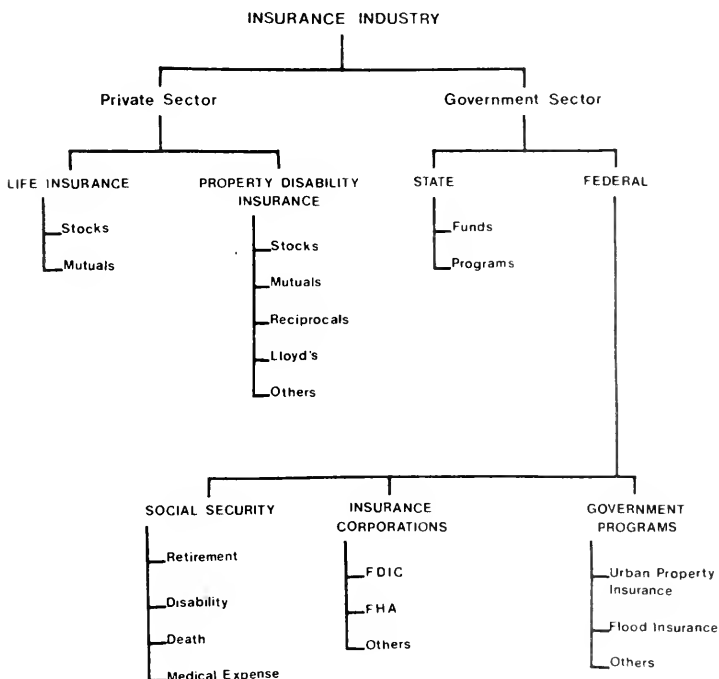
In 1944 the United States Supreme Court overturned the Paul v. Virginia precedent and held that insurance was commerce in the United States v. South-Eastern Underwriters Association (SEUA) ruling.¹ In the court's opinion, combinations of insurance companies designed to fix rates would be in violation of the Sherman Act. Congress moved swiftly to enact legislation designed to clarify the confusing situation caused by the SEUA decision. On March 19, 1945, Congress approved the McCarran-Ferguson Act. The McCarran-Ferguson Act declared in Section 2(a): "The business of insurance and every person engaged therein, shall be subject to the laws of the several states which relate to regulation or taxation of such business." The act provided that no Congressional act shall be construed to invalidate any state insurance legislation, unless Congress shall specifically refer to the insurance industry. It further provided that the Sherman Act, the Federal Trade Commission Act, and the Clayton Act apply to the insurance industry only "to the extent that such business is not regulated by State Law." The structure of the United States insurance industry is complicated and far reaching. Illustration 2-1 shows that insurance is directly related to consumer security and indirectly related to many governmental programs.

Montana began regulating the insurance industry in 1897 with Title 3 of the Civil Code. Under the code, insurance companies were required to be licensed and the State Auditor was assigned the responsibility for licensing insurers and administering regulatory laws. In 1909 the Department of Insurance was created

¹ 322 U.S. 533 (1944).

within the State Auditor's Office, and the State Auditor was designated Commissioner of Insurance, ex officio.

STRUCTURE OF THE U.S. INSURANCE INDUSTRY



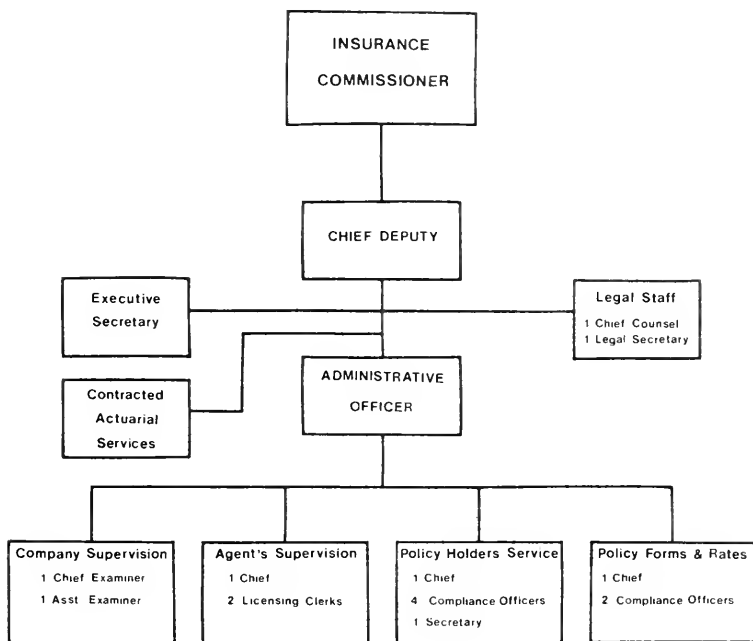
Source: Compiled by the Office of the Legislative Auditor.

Illustration 2-1

DEPARTMENT ORGANIZATION AND FUNDING

As of June 1978, the department had a staff of 19. The staff is organized into four sections, each of which is responsible for particular regulatory functions. The department's

organizational chart and number of employees by section are shown in Illustration 2-2.



Source: Insurance Department

Illustration 2-2

The department's operations are funded through General Fund appropriations. The department collects revenue in the form of premium taxes and licensing and regulatory fees. The department's revenues are deposited to the General Fund and account for approximately 5 percent of all General Fund revenues annually. Illustration 2-3 details the department's financial history from fiscal year 1963-64 to fiscal year 1977-78 (premium taxes are paid in lieu of income taxes and are discussed in greater detail later in this chapter).

Financial History
Insurance Department

<u>Fiscal Year</u>	<u>Revenues</u>	<u>Expenditures</u>
1977-78	\$12,656,322	\$400,108
1976-77	11,239,651	351,641
1975-76	9,483,281	342,775
1974-75	8,323,217	366,842
1973-74	7,366,923	239,480
1972-73	6,812,473	142,711
1971-72	6,115,751	137,565
1970-71	5,383,425	112,156
1969-70	4,931,700	104,101
1968-69	3,822,617	93,376
1967-68	3,517,507	98,028
1966-67	3,415,952	91,338
1965-66	3,167,053	75,499
1964-65	2,977,239	63,833
1963-64	2,854,238	69,168

Source: Compiled by the Office of the Legislative Auditor.

Illustration 2-3

DEPARTMENT OPERATIONS

It was earlier noted that the department is organized into four operating sections. Following is a discussion of each section and its corresponding regulatory activities.

COMPANY SUPERVISION

Company supervision encompasses:

- Determining qualifications of insurance companies by requiring that any insurer transacting business in Montana and not otherwise excepted must be authorized by a certificate of authority.
- Collecting, auditing, and allocating premium tax funds to sources as provided for by law.
- Determining the solvency of insurers through examination of the affairs, transactions, accounts, records, and assets of each authorized insurer.
- Administering insurer security deposits.

Authorization Of Insurers

Montana insurance laws (Section 40-2801, R.C.M. 1947) require insurers to be authorized by the department before selling insurance in Montana with certain exceptions. Since unauthorized companies cannot do business in the state, insurer authorization is the first step in the insurance regulation process.

The authorization process starts with an insurer's request for application forms. Authorization applications are then received and evaluated by the chief examiner and, after consultation with the commissioner and chief deputy, a decision is reached as to whether the company should be authorized. The department then issues a certificate of authority to the authorized insurer or informs the insurer it is not authorized to sell insurance in Montana.

Montana insurance laws established the following qualifications for insurers seeking to conduct insurance business in this state:

1. Must be incorporated or be a reciprocal insurer.
2. Must not have a name so similar to that of another insurer that it would be likely to mislead the public and must not have a name which tends to deceive or mislead as to the type of organization the insurer is.
3. Must have and maintain minimum unimpaired paid-up capital stock (if a stock insurer) or surplus (if a mutual or reciprocal insurer) as follows:

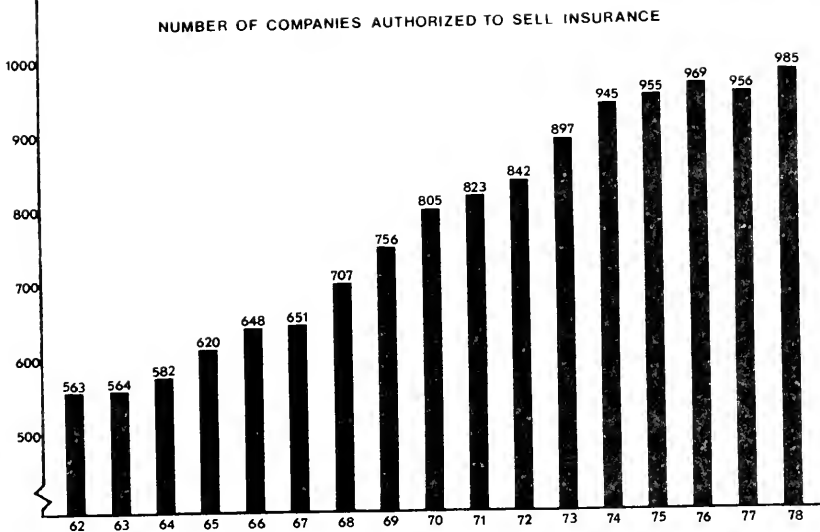
Kind or kinds of insurance	Minimum capital or surplus required
Life -----	\$200,000
Disability -----	200,000
Life and disability -----	300,000
Property -----	400,000
Marine -----	400,000
Casualty	
All lines except workmen's compensation ----	400,000
All lines, including workmen's compensation--	600,000
Surety -----	500,000
Title -----	200,000
Multiple lines (two or more: property, marine, casualty or surety -----	800,000

4. In addition to the minimums noted above, insurers seeking authorization must have at the time of authorization but need not maintain the following surplus depending upon the insurers history or type of insurance sold:
 - a) Insurers with less than 5 years' insurance history must have a special surplus equal to the minimum capital or surplus.
 - b) Insurers with more than 5 years' insurance history must have a special surplus equal to 50 percent of the minimum capital or surplus.
 - c) Insurers transacting multiple lines of insurance must have and maintain a special surplus of \$100,000.
5. Must have on deposit with the commissioner cash or securities in an amount at least equal to the minimum required capital except that title insurers need deposit only \$50,000 and out-of-state insurers may make a like

deposit with the commissioner of its home state rather than with the Montana commissioner.

6. Must have principal management personnel who are trustworthy, of good character, competent to manage an insurance business, and are not affiliated with people who have manipulated assets or accounts to the detriment of insurers, stockholders, or creditors.
7. Must apply to the commissioner for a certificate of authority.
8. Must submit the \$300 fee for filing an application or a retaliation fee, whichever is greater.
9. Must submit various documents including its most recent financial statements and examination report.

As of 1978, 1016 companies were authorized to sell insurance in Montana. Of these insurers, 498 were authorized to sell life and disability insurance and annuities, 444 were authorized to sell general lines and property and casualty insurance, and 74 were authorized to sell other types of insurance. The number of companies authorized to sell insurance in Montana since 1962 appears in Illustration 2-4.



Source: Compiled by the Office of the Legislative Auditor.

Illustration 2-4

Collection Of Premium Taxes

At present, all 50 states and the District of Columbia impose an insurance premium tax on either domestic companies, foreign companies, or both. A "domestic" insurer is one formed under the laws of Montana as opposed to a foreign insurer which is formed under the laws of any jurisdiction other than this state. Montana law states: "Each authorized insurer, and each formerly authorized insurer with respect to premiums so received while an authorized insurer in this state, shall file with the commissioner, on or before March 1 each year a report . . . each such insurer shall pay to the commissioner a tax upon such net premiums, the tax to be computed at the rate of 2 3/4 percent of such premiums." (Section 40-2821, R.C.M. 1947.)

Wet marine and transportation premiums are exempted from the 2 3/4 tax and are taxed separately at 3/4 percent of the gross underwriting profit. There are also Special-Purpose taxes on fire insurance premiums in addition to the 2 3/4 percent tax. These are the 3/4 percent Fire Marshal premium tax, and the 1 1/2 percent Firemen's pension fund premium tax. (Therefore, the total tax on fire insurance premiums is 5 percent--one of the highest in the nation.)

Montana law also imposes a "Retaliation Tax." That is, Montana may tax premiums written in Montana at the Montana tax rate or at the rate imposed by the foreign insurer's state of domicile--whichever is higher. A detailed listing of revenue collections from fiscal year 1961-62 to fiscal year 1977-78 appears in Illustration 2-5.

INSURANCE DEPARTMENT COLLECTIONS FOR THE FISCAL YEAR ENDING JUNE 30

Year	Agent, Etc. Licensing Fees	Company Fees	Fire Marshal Tax	Firemen's Pension Tax	Property Casualty And Misc. Premium Tax	Life And Disability Premium Tax	Retaliation Tax	Health Service Corp.	Total
1962	\$101,165	\$ 48,302	\$ 27,512		\$1,182,796	\$1,086,353	\$ 38,937		\$ 2,445,565
1963	120,955	43,225	27,313		1,290,876	1,154,144	40,458		2,676,971
1964	91,153	59,897	27,818		1,331,861	1,303,426	40,083		2,854,238
1965	89,746	47,196	28,722		1,377,099	1,368,658	45,818		2,977,239
1966	90,004	55,245	29,681		1,460,737	1,460,357	50,828		3,167,053
1967	89,444	51,316	31,860		1,605,392	1,583,304	54,636		3,415,952
1968	91,092	56,418	29,972		1,643,372	1,643,098	53,555		3,517,507
1969	91,037	56,537	34,402		1,786,786	1,774,334	79,021		3,822,617
1970	99,760	253,806	66,952		2,239,370	2,245,201	26,611		4,931,700
1971	102,890	261,364	72,487		2,483,581	2,445,508	17,595		5,183,425
1972	106,524	267,131	129,231		2,921,201	2,665,545	26,119		6,115,751
1973	116,202	292,854	147,819		3,221,340	3,005,581	28,667		6,812,473
1974	126,619	301,538	158,521		3,519,525	3,222,662	37,878		7,366,923
1975	279,201	319,064	182,858		4,013,822	3,687,943	40,329		8,323,217
1976	274,750	309,253	191,133	\$381,684	4,591,501	3,690,125	44,835		9,483,281
1977	268,138	311,295	236,459	472,924	5,804,292	4,054,309	67,425	\$24,809	11,219,651
1978	210,682	458,197	274,848	549,670	6,541,861	4,513,215	84,519	23,330	12,656,312

Source: Compiled from the Insurance Department's records.

Illustration 2-5

Examination Of Insurers

Examination of insurers is a part of the department's regulatory responsibility. The main purpose of the examination is to

independently verify the accuracy of insurance companies' annual financial statements and to determine if the companies have sufficient resources to honor their policies. Other purposes of examinations are to review insurance forms, to determine whether companies' operations are in the public's interest, and to determine whether companies paid the correct amount of tax.

Montana law, in Section 40-2713, R.C.M. 1947, states: "The Commissioner shall examine the affairs, transactions, accounts, records, and assets of each authorized insurer as often as he deems advisable. He shall so examine each domestic insurer not less frequently than every three (3) years." In addition, Section 40-5505, R.C.M. 1947, requires that domestic insurers owned by insurance holding companies with a 15 percent or greater interest must be examined at least once each year.

The examination of insurers is conducted in accordance with the National Association of Insurance Commissioners' (NAIC) Examination Handbook. All 50 state insurance regulatory agencies are members of the NAIC. To eliminate duplicate examinations of multi-state insurers, the states participate in a regional examination system sponsored by the NAIC. Under this system, examinations of multi-state companies are conducted jointly by representatives from several states in which the company does business. The commissioner from each state in which the company is authorized usually accepts the report of the joint examination, but retains the authority to conduct a separate examination if he believes it is necessary.

To accomplish examinations the department employs a chief examiner and one assistant examiner. In addition the department contracts with five field examiners who participate in joint NAIC examinations. Contract examiners are reimbursed for their time and expense by the insurers they examine while the two department employees are paid by the department. The number of examinations which the department has conducted and the number of NAIC examinations in which the department has participated appears in Illustration 2-6 for 1972 to 1977.

Insurer Examinations

Number of Examinations Which the Department:

<u>Year</u>	<u>Conducted Solely</u>	<u>Participated in (NAIC)</u>	<u>Total</u>
1972	1	14	15
1973	2	15	17
1974	6	9	15
1975	2	6	8
1976	3	9	12
1977	6	12	18

Source: Compiled by The Office of the Legislative Auditor.

Illustration 2-6

Insurers' Security Deposits

Section 40-2809, R.C.M. 1947, requires insurance companies to maintain deposits of securities for the protection of policyholders and creditors. Security deposits are administered in three different ways. All Montana domestic insurers deposit the required securities in Montana banks. Deposits are kept in safe deposit boxes and the department has one key and the insurer or its representative, which in many cases is the bank, has the other. Foreign and alien insurers, if required, establish a trust through a bank, and the bank periodically certifies, to the

department, the amounts being held. Out-of-state insurers commonly deposit securities with the insurance regulatory agency of their home state. These agencies then issue certificates to the Montana Insurance Department stating that a certain amount is on deposit in their state for the protection of all the insurers' policy-holders.

Thirteen insurers presently have deposits with the department totaling \$45.5 million. Of this amount, \$31 million is administered by trust arrangements with banks, and the remaining \$14.5 million is being kept in safe deposit boxes accessible to the department. The department's consent is required for the deposit and withdrawal of all securities under its control.

AGENT SUPERVISION

Section 40-3307, R.C.M. 1947, provides that no one in the state shall act as, or hold himself out to be, an insurance agent or solicitor unless licensed to do so. State laws also require insurance adjusters to be licensed. An agent represents an insurance company and, if authorized by the company, may contract for it. A solicitor represents an agent and may solicit insurance applications for such agent but may not contract for the company. An adjuster investigates and negotiates settlement of claims arising under insurance contracts. Agents and solicitors must be licensed for each type of insurance they sell or solicit. Licensed adjusters may adjust losses for all types of insurance.

The insurance regulatory laws prohibit the licensing of agents and solicitors who fail to meet certain criteria specified

in the law. For example, the law requires applicants to be competent, trustworthy, of good reputation, and to have had experience and training, or otherwise be qualified for the license they seek. Section 40-3313, R.C.M. 1947 requires the department to test in writing the competence of each applicant for an agent or solicitor license. Examination for agents must cover all the types of insurance for which the applicant has applied to be licensed as follows:

- Life insurance (no solicitors) - Disability insurance.
- Property insurance.
- Casualty insurance.
- Vehicle insurance.
- Surety insurance.

Applicants for solicitor licenses must also be examined for each kind of insurance, except life, for which their appointing agent is licensed. The examinations for solicitors are exactly the same as the examination for agents.

Applicants who need not be examined are those who: (1) may be licensed under the grandfather clause, (2) are applying for a nonresident license and live in a state that has a reciprocity agreement with Montana, or (3) are applying for a license to sell title insurance or certain other specialty types of insurance. Agent and solicitor examinations are administered by the chief examiner's section. Examinations are given weekly in Helena and once a month in Billings. Examinations are given in other locations when requested. The individual in charge of giving the

examination never corrects and grades the examination. This assures better control and greater accuracy in the examination process. Illustration 2-7 lists the number of examinations given and the pass rate for years 1972-1977. Illustration 2-8 lists the total number of licensees for the past four fiscal years.

INSURANCE EXAMINATIONS
1972-1977

YEAR	TYPE OF EXAMINATION			TOTAL	PASSING PERCENTAGE
	Life & Disability	Multi-Line	Variable Annuity		
72	596	304	58	958	82%
73	802	239	81	1122	79%
74	858	277	34	1169	73%
75	732	331	43	1106	74%
76	770	313	50	1133	72%
77	816	303	32	1151	77%

Source: Compiled by the Office of the Legislative Auditor.

Illustration 2-7

NUMBER OF LICENSEES

FISCAL YEAR	TYPE OF LICENSE			TOTAL
	Agent	Solicitor	Adjustor	
77-78*	5,474	341	135	5,950
76-77	5,264	337	154	5,755
75-76	5,395	249	147	5,791
74-75	4,932	457	137	5,526

*As of March 78

Source: Compiled by the Office of the Legislative Auditor from information available at the department.

Illustration 2-8

POLICYHOLDERS' SERVICE SECTION

Each year many complaints about insurance companies and agents are filed with the department. Review of these complaints is a function of the policyholders' service section which consists of the chief of the section, four compliance officers, and one secretary. Nearly all complaints filed with the department are investigated through telephone conversations or through an exchange of correspondence.

Illustration 2-9 lists complaints and their disposition for years 1974-1977. Complaint resolution is discussed in greater detail in Chapter III.

Department Complaint Resolution

<u>Year</u>	<u>Number of Complaints</u>	<u>Number Valid</u>	<u>Dollars Returned to Policyholders</u>
1974	874 (June-Dec)	286	\$ 563,733.56
1975	1,764	653	996,168.41
1976	2,129	720	817,773.70
1977	2,193	802	1,370,108.62

Source: Compiled by The Office of the Legislative Auditor from information supplied by the department.

Illustration 2-9

POLICY FORMS AND RATES

Section 40-3714, R.C.M. 1947, requires insurance forms and annuity contracts to be filed with and approved by the department before being issued or used in Montana. Other states also require similar advance approval of forms. The department's rates and forms section reviews and approves or disapproves insurance forms filed with the department.

Section 40-3714, R.C.M. 1947, states that the department shall disapprove a form only if the form:

- Violates or does not comply with the code.
- Contains any inconsistent, ambiguous, or misleading clauses, or exceptions and conditions which deceptively affect the risk purported to be assumed in the general coverage of the contract.
- Includes any misleading title, heading, or other indication of its provisions.
- Is printed or otherwise reproduced in such manner as to render any provision of the form substantially illegible.

One example of form disapproval by the department concerns the "adjustable" life insurance policy. The department considers the adjustable life policy too confusing to the consumer and believes it will lead to agent abuse due to its complexity.

The section is staffed by a chief and two compliance officers. The chief of the section reviews property and casualty insurance forms and the two compliance officers review and approve life and disability (accident and health) insurance forms. During the period May 1, 1977 through April 30, 1978, 7,355 life and disability insurance forms and 9,463 property and casualty insurance forms were approved.

In addition to approving policy forms, the section also records rate filings for every insurer, rating organization, and advisory organization. Montana is a "file and use" state, meaning that once a rate is filed with the department, it can be used by the insurer. The rationale behind the "file and use" system, (as opposed to prior approval or departmental rate-setting), is that when adequate competition exists in the insurance industry, prices for the product will also be competitive.

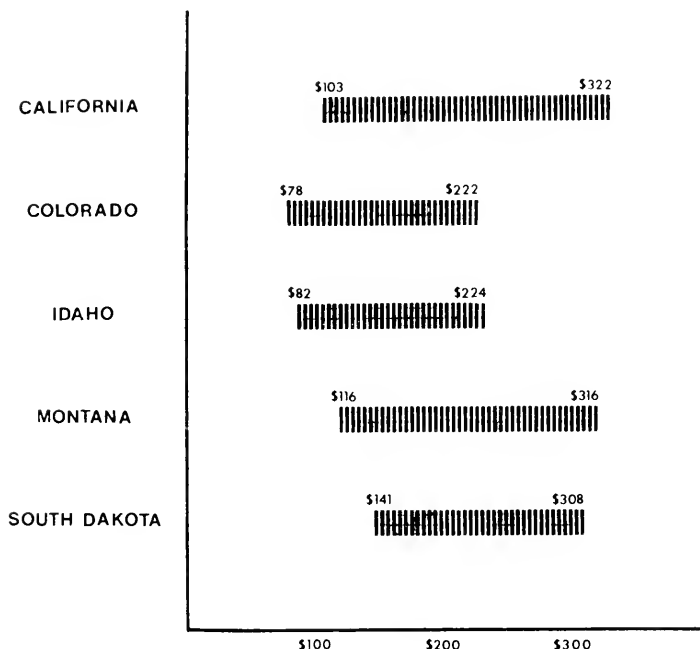
Section 40-3640, R.C.M. 1947, sets the standards which apply to the making or use of rates by stating that rates shall not be excessive or inadequate or unfairly discriminatory. This section of the law gives the department the authority to disallow rate increases or rate reductions. In some cases the department will hold hearings to determine if a rate change is warranted.

During the course of our review, we analyzed the competitive nature of rates in Montana as compared to other states. Illustration 2-10 represents a five state comparison of annual homeowner's insurance premiums. The range includes all geographical zones within a state in a Class 6 fire protection area. (Classes range from 1 to 10.) It can be noted that the rate range charged in Montana is comparable to the range of other states. (We noted similar rate competition existing in the automobile insurance market.)

Of the states listed, South Dakota is the only state which does not allow rates to be filed and used and therefore, is not considered an "open competition" state. The prior approval of rates in South Dakota requires increased regulation and could possibly be the reason for the increase in the low end of the rates range when compared to the other states.

Presently, the department also licenses rating organizations (there are 11 in Montana) whose primary purpose is the making of rates, rating plans, or rating systems on behalf of their member or subscribing insurers. The rates established by rating organizations are advisory only, meaning the members need not adhere to the rates established.

HOMEOWNERS POLICY ANNUAL PREMIUM RANGE*



*Based upon \$50,000 frame construction in a class 6 fire protection area with \$25,000 comprehensive personal liability and \$500 medical payments. Rates used in first quarter of 1978. (This example does not include all premium ranges, but merely evaluates one type of coverage and then compares the cost of this coverage in the various states.

Source: Compiled by the Office of the Legislative Auditor.

Illustration 2-10

SUMMARY

Federal laws place the responsibility for insurance regulation with state governments. Montana began regulating the insurance industry in 1897 and Montana's insurance department was created in 1909. The department is presently staffed with 19 individuals and the department is organized into four major sections. Regulation, as currently administered, involves the examination and

licensing of insurers and those who sell insurance. In addition, the department regulates insurance forms and rates and the department resolves consumer complaints against the insurance industry.

Chapter III

THE RELATIONSHIP OF STATE REGULATION TO THE PUBLIC'S HEALTH, SAFETY OR WELFARE

This chapter addresses two questions posed by the sunset law: Would the absence of regulation significantly harm or endanger the public's health, safety, or welfare? Is there a reasonable relationship between the exercise of the state's police power and the protection of the public's health, safety, or welfare? In defining the purpose of sunset legislation, Montana's sunset law (Section 82-4601, et seq., R.C.M. 1947) states that "The legislature questions whether conditions causing the establishment of these agencies, programs, and rules have not changed to such an extent as to remove the need for some or all of the agencies, programs, and rules." Accordingly, this chapter discusses whether a public need continues to exist for the regulation of the insurance industry in Montana. The chapter then discusses whether the current exercise of the state's police power, through regulation by the department, is reasonable.

USE OF INSURANCE

The business of insurance in the United States is divided into three broad categories: life insurance, health insurance, and property and liability insurance. There are nearly 4,700 insurance companies domiciled in the United States. Some of these companies sell all types of insurance and many specialize in one or more fields. Altogether the insurance industry provides about 1,700,000 jobs and the industry is responsible for assets of more than \$400 billion.

The economic role of insurance was expressed in a definition used by former United States Assistant Attorney General Wendell Berge in an address to the New England Association of Insurance Agents: ". . . A mechanism for minimizing the fortuitous risks of life so that man's energies will be more free to assume other risks in adventurous grappling with those problems he has a chance to solve."¹ It has been said that because of insurance coverage, American business owners, employees, and homeowners, have more financial protection and a greater sense of security than any other people in the history of the world.

The insurance industry and its effect on the economy is no less important in Montana than in the United States. In 1977 Montanans paid out over \$389.7 million in insurance premiums to 1,016 insurance companies licensed by the department. If evaluated on a per capita basis, the 1977 insurance premiums paid out by each man, woman, and child in Montana would amount to approximately \$520 per person. As noted in Chapter 2 the premium taxes and fees paid by insurance companies contribute 5 percent of Montana's total General Fund revenue.

REGULATION OF INSURANCE

Through the years, numerous court cases have examined the rights of insurance companies to do business and the individual states' right to regulate that business. Corpus Juris Secundum (C.J.S.), a legal encyclopedia, states: "The insurance business

¹ George L. Granger, Doctorial Dissertation, "State licensing requirements for insurance agents and brokers," University of Pennsylvania, p. 4.

is affected with the public interest, and it is competent for the state, under its police power or as creator or controller of corporations, to determine who may engage in the business within its boundaries, and to prescribe terms and conditions on which the business may be conducted, and generally to regulate the business and all persons engaged in it," C.J.S. further states: "The regulatory power of the state depends on the particular circumstances of the situation, and may, and should, be exercised to safeguard and protect the insurance business, as well as to safeguard policyholders and the general public of the state."¹

In the case of Springfield Fire and Marine Insurance Company v. Holmes, D.C. Mont.,² the court determined that public necessity, interest, or need and not private advantage or gain, justifies regulation of the business of insurance; a regulatory statute must be in response to a public need and must provide a means appropriate to that end.

To further document the need for state regulation of insurance, American Jurisprudence states: "The organization of an insurance company and the conduct of the business of writing insurance is not a right but a privilege granted by the state subject to the conditions imposed by it. It is generally recognized that the business of insurance is one that is affected with a public interest, and that it is a proper subject of regulation

¹ 44 C.J.S., Insurance, Section 56, p. 518.

² 32 F. Supp. 964.

and control by the state by virtue of the exercise of its police power, in the interest of public convenience and the general good of the people. Indeed, it is not only the right but also the sovereign duty of a state to regulate the business of insurance."¹

As discussed in Chapter II, U.S. Congressional passage of the McCarran-Ferguson Act in 1945 established with the states the power to regulate and tax the business of insurance. Because of the McCarran-Ferguson Act, the tendency might exist to believe insurance regulation is purely a state function. Actually both the states and the federal government are extensively involved in a dual form of insurance regulation. The following is a partial listing to show the complex nature of the present insurance regulatory environment.

State Regulation

- a. Review rates and/or approve rating plans.
- b. Financial examination of insurers and regulation for insurer solvency.
- c. Formation of company.
- d. Admission of company insurer authorization.
- e. Qualifications of officers.
- f. Qualifications and licensing of salespersons.
- g. Qualifications and licensing of claims personnel.
- h. Regulation of residual market mechanisms.
- i. Market surveillance.
- j. Taxation.

Federal Regulation

- a. SEC regulations apply to some aspects of insurance accounting and to companies with publicly traded stock.
- b. Annuity contracts are regulated under the Investment Companies Act of 1940.
- c. Federal Trade Commission regulates insurance company mergers, advertising of mail order insurance, etc.
- d. HUD, through the Federal Insurance Administrator, regulates the flood, crime, FAIR Plan and riot reinsurance programs.

¹ 43 Am. Jur, 2d, Insurance, Section 52, p. 108.

- e. The Interstate Commerce Commission specifies coverages required of interstate carriers.
- f. An international agreement negotiated by the federal government establishes civil liability for airline passengers in international travel.
- g. The Price-Anderson Act determines limits of liability and establishes absolute liability on operators of nuclear reactors.
- h. The Small Business Administration administers the Surety Bond Guarantee Program.
- i. HEW and the Labor Department are involved in the Black Lung Program for coal miners.
- j. Federal wage and price controls were applied to insurance wages and premium rates.

WOULD THE ABSENCE OF REGULATION HARM

Department officials stated that insurance regulations exist because someone abused the system and caused someone else harm. Therefore, to view insurance in the absence of regulation, a look back into history is required to trace the reasons for the regulatory structure we have today.

Before the era of company supervision and state regulation, numerous companies were established in all sections of the United States, many of them on very insufficient capital. The administration of these "wildcat" companies was characterized by the use of reckless, unsound and outright dishonest business practices. It is an established fact that unrestricted price competition was a major cause of insurance company insolvency in the early days.¹

Through current state regulation, insurance company insolvency is no longer the problem it was in earlier years. Today insurance companies are evaluated prior to licensing to make certain the companies are financially solvent. In addition,

¹ Vance On Insurance, William R. Vance, West Publishing.

companies must maintain minimum capital reserves and the companies are periodically examined to evaluate solvency.

When all these state regulatory measures fail and a company becomes insolvent, insurance guaranty funds implemented by the state come into effect and the insurance consuming public is protected. Montana, along with 47 other states, has guaranty fund laws for property-casualty insurance. Twenty-two states, including Montana, also have life and health insurance guaranty funds.

All companies who sell the above types of insurance must participate in the financing of the guaranty fund. When a company becomes insolvent, the solvent companies are assessed funds on a proportionate premiums earned basis to cover consumer loss. In the last three fiscal years, the Montana Insurance Guaranty Association has paid to consumers over \$600,000 to cover company insolvency and resulting consumer loss of premiums and unpaid claims.

During the course of our audit we asked many insurance groups and associations to answer the questions of the sunset law. One insurer answered the question of absence of regulation in the following manner:

"One of the fundamentals of the Alliance is to encourage regulation beneficial to the public interest. The major purpose of insurance regulation is to protect the public from the hazards of company insolvency. Policyholders pay premiums to obtain coverage for future loss exposure. Regulators establish financial prerequisites necessary for obtaining a license to do business, conduct periodic financial examinations and analyze reserve adequacy so that the consumer can be assured his future covered loss will be paid by the responsible company. Without proper regulation there

would be no guarantee an insurer would have adequate funds to pay the legitimate future claims of its policyholders."¹

Historians have also recorded instances where consumers have been harmed due to improper actions by those who sell insurance. Insurance agents at the turn of the century have been typified in many accounts as being poorly trained and greedy. Rebating which is the payment of a portion of the commission by an agent to a prospective insured as an inducement to take out a policy was common practice. Agents often made promises they knew could not be kept but which were calculated not to come to light for years.² The complicated product of insurance, added to the large amounts of money involved, encouraged agent abuses through the years. Some of these problems continue into the present day in Montana i.e., misrepresentation of policy coverage, withholding of premiums, and selling without a license.

Today, agents in Montana are regulated by the Montana Insurance Code which gives the department the general power to grant or cancel a license. Agents must meet pre-license criteria such as the passage of an examination. In addition, the agent's license is subject to revocation should practices such as misrepresentation be employed.

In the event the Montana consumer has a complaint against an insurance company or its agent, the department may investigate and resolve the complaint. In the absence of regulation this

¹ F.A. Holderman, Vice President, Alliance of American Insurers, correspondence with the Office of the Legislative Auditor, March 20, 1978.

² Vance On Insurance, William R. Vance, West Publishing.

option would not be available and the consumer would have to employ the services of an attorney to resolve the problem. The policyholders service section of the department has resolved many complaints on behalf of the consumer. In fact, the department estimates that it has helped to return over \$3.7 million to the consumer between June 1974 and December, 1977.

In summary, courts have ruled that the business of insurance affects the public and should be subject to state regulation. Without regulation, the consumer would suffer financial harm due to company insolvency and problems relating to agent misrepresentation, etc. Even with present regulation there are many examples of consumer harm. These situations are often resolved by the current regulatory process through which the consumer may have a complaint investigated and resolved. Therefore, we must conclude that the absence of insurance regulation would harm the public.

EXERCISE OF THE STATE'S POLICE POWER

The second section of this chapter answers the question: Is there a reasonable relationship between the current exercise of the state's police power and the protection of the public's health, safety, or welfare? As earlier discussed, there has been considerable case law indicating that the state should regulate the insurance industry if the public is to be adequately protected. Therefore, the question is not whether the regulation of insurance should be performed by the state, but rather what extent and degree of regulation is needed to adequately protect the public.

It can be said that insurance in Montana is big business and that the state has a vested interest in retaining and encouraging

the growth of that business. It can also be said that insurance is a business for consumers and these consumers must be protected through the enforcement of the insurance laws and rules of the state of Montana. In any organization that is tasked with the responsibility of encouraging an industry, as well as regulating that industry, a balance must be struck. Over-regulation of insurance can have as harmful an effect on the consumer as under-regulation. As an example, insurance companies do not have to do business in Montana. If regulation becomes excessive and profitability declines, companies will not operate in Montana thus reducing competition and increasing costs for consumers. With under-regulation, company insolvencies increase, and the consumer again suffers financially. It is the purpose then of this section to analyze the present regulation of insurance in Montana and determine if the current exercise of the state's police power is reasonable.

COMPANY SUPERVISION

Of the four main sections of the Insurance Department's regulation structure, the company supervision section is the most diverse in terms of duties to be performed. The Chief Examiner and Assistant Examiner comprise the section and their responsibilities include:

- Reviewing applications of companies initially desiring to do business in Montana.
- Determining the adequacy of prospective companies' financial situation for entry into the insurance industry.
- Collecting licensing fees and general fees and collecting the minimum capital or surplus required by Section 40-2807, R.C.M. 1947.

- Supervising the examination of domestic and foreign companies and domestic holding companies.
- Collecting annual statements for all companies authorized in Montana.
- Examining farm mutual insurers.
- Collecting premium taxes from all insurers.
- Auditing annual statements to determine correct premium tax payment.
- Administering payments to firemen's and policemen's pension funds from premium taxes and special purpose taxes.
- Working closely with the N.A.I.C. "early warning system" to identify companies with insolvency trends.
- Managing 5 contract examiners usually working out of state.
- Valuing securities to determine adequate reserve levels.
- Administering the Montana Insurance Guaranty Association.
- Monthly servicing of insurers security deposits.
- Examining and licensing rating bureaus.
- Examining and licensing insurance consultants.
- Administering and grading weekly examinations.
- Working with N.A.I.C. and other states to improve other insurance regulations in Montana.

Of all the duties of the chief examiner, probably the most important is the examination of insurance companies. The main purpose of examinations is to independently verify the accuracy of insurance companies' annual financial statements and to determine if companies have sufficient resources to honor their policies.

Section 40-2713, R.C.M. 1947, states that the commissioner shall examine the affairs, transactions, accounts, records, and assets of each authorized insurer as often as he deems advisable.

He shall so examine each domestic insurer not less frequently than every three (3) years." The examination of domestic insurers is being accomplished at least once every three years. Section 40-5505, R.C.M 1947, states that every domestic insurance company whose stock is held 15% or more by a holding company must be examined not less frequently than once a year.

Presently, 7 of the 11 domestic insurers are owned in whole or in part by insurance holding companies and, to the chief examiners knowledge, the yearly examination requirement for insurers owned by holding companies has not been complied with since the law came into existence in 1967. Illustration 3-1 details the holding companies, corresponding domestic insurance companies, and when an examination of the insurance company should have been accomplished to comply with state law. The illustration shows that not one of the companies has been examined in accordance with the annual examination requirement for domestic insurers owned by holding companies.

EXAMINATION OF DOMESTIC INSURERS
OWNED BY HOLDING COMPANIES

<u>Holding Company</u>	<u>Domestic Insurer</u>	<u>% Owned By Holding Company</u>	<u>Last Examined</u>	<u>Proposed Examination Schedule Of Department</u>	<u>Should Have Been Examined By:</u>	<u>Examination Past Due</u>
1 (Domestic)	A	44.95	12/31/76	12/31/78	12/31/77	Yes
2 (Foreign)	B	84.0	12/31/76	12/31/79	12/31/77	Yes
3 (Domestic)	C	100.0	Not yet examined	Not available	5/26/78	Yes
4 (Domestic)	D	100.0	12/31/75	12/31/78	12/31/76	Yes
	E	44.04	12/31/75	12/31/78	12/31/76	Yes
5 (Domestic)	F	100.0	12/31/76	12/31/79	12/31/77	Yes
	G	100.0	12/31/76	12/31/79	12/31/77	Yes

Source: Compiled by the Office of the Legislative Auditor.

Illustration 3-1

It should also be noted that in Illustration 3-1 holding companies 1, 3, 4, and 5 are domestic insurance holding companies. Section 40-5505, R.C.M. 1947, requires that every domestic insurance holding company be examined at least once each year. Since the law was enacted in 1967, none of the four domestic holding companies have ever been examined. We discussed this point with department officials. Officials stated that they rely upon audited annual financial statements and annual reports to the SEC.

Section 40-5512, R.C.M. 1947, enacted in 1971, requires that every insurer which is authorized to do business in this state and which is a member of an insurance holding company system shall register with the department, unless it is a foreign insurer coming from a state whose holding company registration statutes are similar to Montana's. The department interpreted the law to mean that insurers, which were members of holding companies at the time of enactment of the 1971 law, were "grandfathered" and not required to register. Therefore, no company has been registered under this section. Section 40-5512, R.C.M. 1947, required all insurers subject to registration to register within 60 days of the effective date of the act, regardless of whether or not they were licensed in Montana at the time the registration requirement was passed. Only insurers who are owned by holding companies domiciled in states with similar registration statutes are exempt. During the conduct of this audit, the department did not have a list of states which have holding company disclosure

requirements similar to the Montana requirement.* Without this list, there is no way to determine if foreign insurers are in compliance with the registration of insurers requirement established by Section 40-5512, R.C.M. 1947.

The department also has the responsibility of licensing insurance rating organizations that operate in Montana. Rating organizations or bureaus formulate rates on behalf of their member companies and because of Montana's open competition law, the companies can charge the bureau rates or establish their own rates.

Section 40-3647, R.C.M. 1947, requires rating organizations to file the following with the commissioner before they can be licensed in Montana:

- 1) A copy of its constitution or articles of incorporation.
- 2) A list of its members and subscribers.
- 3) Name and address of the Montana resident for service of process.
- 4) Statement of qualifications as a rating organization.

There are currently eleven licensed rating organizations in Montana. Only four organizations had all of the above requirements in their files with the department. Seven others were missing at least one or more of the documents required for licensure.

Section 40-3655, R.C.M. 1947, enacted in 1969, requires that the department examine each licensed rating organization at least

*Department officials have stated that a list is now available.

once every five years. In lieu of any such examination, the commissioner may accept the report of examination from an official of another state. The department had no record of when the licensed rating organizations were last examined and did not know that two rating organizations domiciled in Illinois are no longer subject to the Illinois examination which the department depends upon. We determined that of the eleven licensed rating organizations, at least five had significantly gone past the five year examination requirement.

Farm mutual insurers principally insure farm dwellings and other farm property against loss or damage by fire or other casualty. Currently, 100 or more persons who collectively own \$500,000 or more in farm property, may form a farm mutual company. Farm mutuals are presently 14 in number and they insure millions of dollars in Montana farm property annually.

Section 40-4834 R.C.M. 1947, gives the commissioner the power, at any time to investigate and examine the affairs and books of any insurer. Two farm mutuals were examined in 1975 and the other 12 have not been examined for an undetermined length of time, if at all. Although there is no mandatory periodic examination requirement established by law, the members of farm mutual insurers are consumers of insurance and as such, should be provided protection through some type of periodic company examination by the department.

AGENT SUPERVISION

The agents' licensing section in the department is responsible for licensing individual agents, solicitors, and adjusters.

As discussed in the previous chapter, licensees must be competent, trustworthy, of good reputation, and have had experience and training or otherwise be qualified for the license they seek. Additionally, applicants for licensing must be 18 years of age and, in most cases, must be a resident of the state unless the licensee is a nonresident from a state with a reciprocal licensing agreement with Montana.

AGENT EXAMINATIONS

Section 40-3313, R.C.M. 1947, states that after completion and filing of the application for license, the department shall subject each applicant for license as agent or solicitor to a written examination as to his competence to act as such agent or solicitor. The department requires a written multiple choice examination for the following licenses (70 percent is passing):

- Life insurance.
- Disability insurance.
- Property insurance.
- Casualty insurance.
- Vehicle insurance.
- Surety insurance.
- Variable annuities (must also take life examination).
- Credit life and disability.

The department presently gives insurance examinations five times a month in the state. Applicants at the examination site give their names to the examination administrator. From a card file the administrator determines they are registered to take a

given examination. The applicants are then given a copy of the examination and answer sheet. Presently, there is no positive identification system being implemented, i.e., Montana driver's license, and there is no space on the answer sheet for the applicant's personal signature. The possibility exists for a person to take the insurance examination on behalf of another.

Currently, all 50 states license their agents through written examination. The Montana Insurance Department has been licensing agents via a written examination since 1961. The type of examination, number of versions, and number of questions appears in Illustration 3-2.

INSURANCE EXAMINATIONS

<u>Type of Examination</u>	<u>Number of Versions</u>	<u>Number and Types of Questions</u>
Life and Disability	2	50 General, 50 Life, 50 Disability
Life only	2	50 General, 50 Life
Disability only	2	50 General, 50 Disability
Full Multi-Line	2	25 General, 25 Property, 25 Casualty, 20 Vehicle, 5 Surety
Property, Casualty, Vehicle	2	25 General, 25 Property, 25 Casualty, 25 Vehicle
One General Line Only	2	50 General, All questions of Line to be examined
Credit Life and Disability	1	50 questions
Variable Annuities	1	50 questions

Source: Compiled by the Office of the Legislative Auditor.

Illustration 3-2

The composition of a meaningful examination is not a simple task. The quality of the examination should reflect the intent of the state licensing requirement, i.e., protection of the public. According to insurance examination literature, the number of insurance examination versions, the number and type of questions which make-up the examination, and the frequency which it is given are factors dictating how often an examination should be revised. For example, the more frequently an examination is given, the more frequently it should be revised.

The "General lines" and "Life and Disability" examinations were last revised in 1974. The Variable Annuities examination has never been revised and is at least 13 years old.

The examinations were analyzed for question content and make-up and the results are as follows:

- Two questions, one in each version of the Vehicle section, were outdated by a legislative amendment in 1975, thus making a correct response impossible.
- One question is asked in both versions of the Property examination, but one version has an omitted word which significantly alters the question meaning and causes confusion.
- Five questions are self-answering in that a choice of (d), which reads "Any of the above" or "Any or all of the above" will always be the correct answer.
- Although the department alternates the use of the two versions of the Life and Disability examinations and the two versions of the General Lines Examination, for both examinations there is over a 90% correlation for identical question wording and format between revisions. Only question order has been changed.
- The Variable Annuities examination is at least 13 years old. It contains numerous questions which are outdated.

The effect of an invalid agents' licensing examination is two-fold. Agents who should have passed the examination could fail and are inconvenienced because of confusing and outdated questions. Also, agents who should have failed the examination are passed because of the self-answering questions. We analyzed specific examination answer sheets and noted instances where both of these problems could have occurred.

During the course of our audit we discussed examination problems with the department. We learned that the department has now corrected examination deficiencies and all examinations have been revised through the assistance of Drake University (with the exception of the variable annuity examination).

LIFE AGENT PROPOSAL REQUIREMENTS

The department administers several rules which are designed to protect the life insurance buying consumer. These rules, adopted in the Administrative Rules of Montana, require that any solicitation and/or sale of life insurance, mutual fund, or other security be made to the consumer in the form of a complete, clear, and unambiguous written proposal. A copy of the proposal must be given to the consumer at the time the solicitation, proposal, or application is made. Another copy must be retained by the agent or agent's company for a period of at least 3 years.

The purpose of this rule is to protect the insurance buying consumer through adequate disclosure of the actual life insurance policy provisions during the initial proposal of insurance. Proposal retention also protects the consumer in the event of conflict

between what was represented by the agent and what was actually provided for in the company's policy.

For this audit, a random, anonymous sample of life insurance agents from across the state was sent questionnaires to determine opinions and operating practices being used.

--Agents were asked for which type of life insurance a formal written proposal was presented to the client? 11.7 percent responded that no written proposal was even given at all.

--Agents were asked if a formal proposal is presented, is it retained by the agent and/or the company. 13.7 percent responded that no copy was kept by the agent or by the company.

--Agents were asked how long a copy of the proposal was retained. 70.8 percent were not complying with the 3-year retention time period and most who were retaining proposals were doing so for less than 6 months.

--Agents were asked if they retained a copy of the proposal when no sale was made. Regardless of whether a sale is made, agents are required to keep the proposal copy for 3 years. 32.5 percent were not retaining a copy of the proposal.

We discussed the apparent noncompliance by agents with department officials. Officials stated that the administrative rule, as printed, is contrary to the original intent of the rule. Officials noted that the proposal rule is enforced only when life insurance is sold in conjunction with mutual funds. Officials also stated that published guidelines given to agents required compliance only when mutual fund sales are involved.

Full policy disclosure is an important consumer safeguard. Our sample indicates that proposal requirements under the administrative rules of Montana are either being ignored or the agents and companies are simply unaware of the requirements. For those

agents in our sample that are making formal proposals, the majority are not retaining the proposals at least three years as required by the Administrative Rules of Montana.

AGENT EXPERIENCE AND TRAINING

Section 40-3309, R.C.M. 1947, states that a prospective life or disability agent "must have had experience or training, or be otherwise adequately qualified in the kind or kinds of insurance as to which he is to be licensed." Section 40-3308, R.C.M. 1947, also requires experience or training for agents applying to sell insurance other than life insurance. Although the law requires experience or training prior to licensing, the law does not specifically define what is acceptable training or experience.

Several states require a given number of training hours (usually in property-casualty) before applicants are allowed to take an examination. In the department's application for licensure, two questions are asked: (1) What instruction in insurance have you had? and (2) What insurance instruction do you expect to receive? The necessity for training is established in the law but the department enforces no specific requirement for training prior to examination. In fact, if an applicant is otherwise qualified, he is licensed. In addition, the department has no rule or guideline regarding what training or experience is acceptable.

It could also be argued that if there is a need to evaluate applicant competency through an examination, then the maintenance of competency is also important. Currently there is no provision in the law for agent retesting or continuing education. In

other words, once an agent is licensed and presumed to be competent, there is no further assurance that competency is maintained.

Several states have passed laws that require agent retesting or continuing education. Delaware, for example, requires every insurance agent to pass a written examination every five years. The examination covers changes in statutes and regulations during the preceding five years. Kansas has enacted a law which establishes educational requirements for agents. The law is patterned after a model National Association of Life Underwriters law which requires the completion of one of five courses within five years of initial licensing.

POLICYHOLDERS' SERVICE

The Policyholders' Service section was created by the department in answer to a need to provide the insurance buying public with a way to resolve insurance complaints. There are no statutes explicitly directing the department to receive or process complaints, but the need has clearly been established and funding has been in effect since 1965.

As briefly discussed in Chapter II, complaints received fall into one of three insurance categories: property and casualty, life and health, and health service corporations. The following is a list of typical complaints which the Montana insurance consumer brings to the department for resolution:

Claim Handling:

--Delays.

--Denial of claim.

- Return of premium.
- Cancellation of policy.
- Refusal to insure.
- Unsatisfactory settlement/offer.

Agents:

- Misrepresenting policy terms and inadequate disclosure of policy terms.
- Misstating information on a application and later company denial.
- Misappropriation of premiums; not sending premium with application, failing to return premium after termination.
- Twisting, where the agent's motive is to induce an insured to switch policies by downgrading the existing policy and/or exaggerating the value of the proposed one.

A Policyholders' Service section of a state insurance department needs to be constantly analyzing and using the information that comes to it through insurance complaints. Proper statistical recording and analysis provides an important regulatory function by identifying items such as:

- Areas for needed legislation.
- Trends on the operations of agents.
- Problem companies.
- Problems with certain insurance forms and types of insurance.
- Misleading advertising.

Presently, the Policyholders' Service section is recording:

- The number of complaints against agents and companies (both valid and invalid) on a monthly basis.
- Dollar amounts returned to policyholders.

--The number and name of individuals who inquired or filed a complaint.

--The number of open and closed files per month.

The Policyholders' Service section is recording information and filing information but it is not implementing even the simplest of statistical methods to use the information and increase its regulatory ability and overall identification of problem areas in the Montana insurance industry. The section can identify the total number of complaints per company but it has no way of telling if the number of complaints per company is excessive in relation to the number of policies sold or premium dollars received. A simple ratio of valid complaints to premiums collected would put all companies on an equal basis and easily identify companies which were causing excessive problems for consumers.

The section does not categorize and analyze complaints by type of insurance and thereby has no means of determining if certain types of insurance are causing an increase in complaints. Complaints analyzed by line of insurance could identify important trends and areas needing investigation. The section currently uses the NAIC model complaint form which is used to start each complaint file. If this form was completely filled out, the department would be able to compile useful complaint statistics. A random sample of complaint files was selected and 46 percent of the sample complaint forms were found to be incompletely filled out. Many categories on the forms were not filled out, such as "Nature of Complaint."

Complaints against agents and companies are grouped together in a monthly listing. The section does not separate the agents from companies in complaint totals and does not determine, as a matter of procedure, if agents' complaints or company complaints are increasing or decreasing. This statistic could be an important tool for allocation of manpower.

The Policyholders' Service Section presently uses a procedure which calls for the investigation of an agent after five valid complaints are lodged against that agent. At the discretion of the chief deputy, an investigation of a company may be initiated after ten valid complaints. Section 40-2704(5), R.C.M. 1947, states: "The commissioner shall appoint and employ a field investigator whose primary duty it shall be, as directed by the commissioner, to make investigations in this state of violations or claimed violations of this code." The department does not have a full or even half-time field investigator. We discussed this point with department officials. Officials informed us that the department has employed a field investigator in the past, but no longer believes a full-time position can be justified. A compliance officer with expertise in a given area of insurance may go out and do field investigation work but we found this to be a very rare occurrence. Complaint handling in the department is almost entirely done through written or telephone correspondence.

POLICY FORMS AND RATES

One primary function of the Policy Forms and Rates Section is the screening and approval of all insurance policy forms

before they are used by companies authorized in Montana. Another function of the section is the filing and monitoring of rates being charged by companies selling property-casualty and workmens' compensation insurance.

FORM APPROVAL

The approval of policy forms prior to use has an important regulatory effect on insurance policies sold in Montana. In a dispute between a consumer and a company, if an unapproved form is involved, the company is without legal recourse. In addition, the form may be disapproved if it is misleading.

Many insurance forms contain certain trade terms along with other legal terms that are given special meaning. Some states have laws requiring insurance contracts to be written in "plain English" or ordinary layman's language. Montana does not have "plain English" requirements but it benefits, to some extent, from the states that have the "plain English" requirement.

The insurance form is a complicated product involving legal technicalities which few consumers understand. The consumers' need for the product and general unfamiliarity puts the consumer in a very compromising position. Anything that will help the consumer better understand the product he is buying should be considered.

We evaluated insurance forms that have been approved in Montana. In one case, we noted that the introductory statement to one form contained 236 words in the first sentence. The following was taken from another policy written in Montana by a large insurance company:

Loss Payable Clause - Insured Property Section

Loss or damage, if any, under the Insured Property Section shall be payable as interest is indicated on the policy or endorsement thereto, and such insurance as to the interest of the bailment lessor, conditional vendor or mortgagee or assignee of bailment lessor, conditional vendor or mortgagee (herein called the lienholder) shall not be invalidated by any act or neglect of the lessee, mortgagee or owner of the within described property nor by any change in the title or ownership of the property; provided, however, that the conversion, embezzlement or secretion by the lessee, mortgagor or purchaser in possession of the property insured under bailment lease, conditional sale, mortgage or other encumbrance is not covered under such policy, unless specifically insured against and premium paid therefor; and provided, also, that in case the lessee, mortgagor or owner shall neglect to pay any premium due for any such coverage the lienholder shall, on demand pay the same.

Although the necessity for this language is questionable, it exemplifies the technical nature of the insurance contract and demonstrates the reason why consumers should be protected through approval of insurance forms.

Section 40-3714, R.C.M. 1947, requires insurance forms and annuity contracts to be filed with and approved by the department before being issued or used in Montana. The possibility exists that unapproved insurance forms are being used in Montana. In one sample of forms used by a domestic company, we determined that one form had not been approved. After bringing this to the company's attention, the form was submitted for approval within the week. Another sample of property-casualty forms and form numbers was collected from insurance agencies in one city to check them against the form numbers on file in the department. Agents informed us the forms were being used in Montana, but we could find no record of form approval at the department for some

of the sample forms and form numbers. When a company fails to file a form, the state loses the form approval fee. More importantly, the consumer may purchase a policy that contains misleading information which might have otherwise been disapproved by the department had the form been filed.

Section 40-3702, R.C.M. 1947, defines a "policy" as a written contract or written agreement for or effecting insurance, by whatever name called, and includes all clauses, riders, endorsements and papers which are a part of the policy. The sale of life insurance to college students often involves a promissory note covering premiums. Promissory notes have been a source of problems but the Rates and Forms Section has not considered the notes a part of the policy and therefore not subject to approval. In the Administrative Rules of Montana (ARM), Section 6-2.6(6)-S700(4), "Promissory notes," states that a copy of the note must be attached to the policy. The section was not enforcing the requirement in the ARM that requires all college life sales materials to be approved before use. Presently, college life sales materials and notes are not being filed, approved, and monitored by the department.

RATE APPROVAL

When an insurance company changes its rates, either up or down, the department requires that the company supply financial information and reasons for the rate change. The department presently uses the company's loss ratio as a measuring device. This ratio is the premiums earned to the total losses incurred.

As a rule of thumb, a 55 percent loss ratio is used as a mid-point by the department to judge company profitability and loss experience. When the percent of losses is over 55 percent, the department usually determines that a rate increase is justified. When the percent of loss is less than 55 percent (meaning the company's profit margin is increasing), the department usually will not challenge a rate decrease.

An insurance company can have losses for many reasons, including poor management or poor underwriting practices. The department does not specifically concern itself with why a company's losses are high if the company's loss ratio meets the 55 percent guideline. A rate increase from a company with the above mentioned problems would presently go unnoticed because the company would have a high loss ratio.

Section 40-3654, R.C.M. 1947, (2), states that "Every insurer shall in addition file with the commissioner all rates that the insurer uses within this state." The Rates and Forms Section is presently not enforcing the requirement that members of rating organizations must file the rates they use with the department. Under the present law, even if members use rating organization rates, members are not excluded from the rate filing requirement and should be filing the rates they use.

Section 40-3640, R.C.M. 1947, sets the standards applicable to rates by requiring that "Rates shall not be excessive or inadequate nor shall they be unfairly discriminatory." Although the department does not set or make insurance rates, the department

can challenge the rate changes. To adequately monitor the rates charged, all Montana insurers with the rate filing requirement should be required to individually file the rates they use.

Rating organizations establish rates on behalf of their members and it is the member company's option to deviate from those rates. Rating organizations base rates on average losses for all companies involved and a rate increase from a rating organization does not include a breakdown of the loss ratios for each member company. Therefore, a highly profitable company which is a member of a rating organization can use the rate increases of the organization when the profitable company might have otherwise been denied the rate increase because of high profitability and a low loss ratio.

SUMMARY

This chapter has addressed two questions of the sunset law. The first question asked if the absence of regulation would harm the public. We noted that the courts have ruled insurance is a business affected with the public interest. We also projected that in the absence of regulation insurance companies would not be regulated such that insolvencies could be prevented or provided for as is presently the case. Finally, we pointed out that even with the present regulation system the consumer may be harmed. If the consumer takes a complaint to the department, in many cases the complaint is resolved. Based upon this information we concluded that the absence of insurance regulation would harm the public.

The other sunset question addressed in this chapter asked if there is a reasonable relationship between the exercise of the state's police power and public protection. To answer this question we evaluated the department's current regulation of the insurance industry in Montana. The evaluation disclosed instances where the department was not complying with certain state laws. In addition, problems were noted with present methods of regulating insurance companies and agents. Based upon our findings, we conclude that improvements in the state regulatory process should be considered in the following areas:

- 1) Insurers and Holding companies should be audited in accordance with the laws.
- 2) Farm Mutual Insurers and foreign insurers owned by Holding companies should be more closely monitored.
- 3) Agent examinations should be updated periodically and examination security should be monitored.
- 4) A list of agent suspensions and revocations from all states should be maintained.
- 5) Life insurance proposal rules should be enforced or if the printed rules are contrary to original intent, a rule change should be initiated.
- 6) Agent education and experience guidelines should be established.
- 7) Complaint forms should be completely filled out and statistical data should be analyzed.
- 8) The department should appoint a full-time field investigator in accordance with the law or seek a change in the law.
- 9) Forms in use should be periodically spot-checked and forms with misleading language should be disapproved.
- 10) Rate changes should be more closely scrutinized.

- 11) All insurers should be required to file rates regardless of whether or not rating bureau rates are used.
- 12) Rating bureaus should be analyzed to evaluate their impact on competition.

Chapter IV

THE REGULATORY PROCESS

This chapter addresses a third question posed by the sunset law: Are all facets of the regulatory process designed solely for the purpose of, and have as their primary effect, the protection of the public?

CONSUMER PROTECTION

In past years, insurance departments in many states, Montana included, have prided themselves on the low percentage of expenditures used for operation when compared to the revenues taken in through company premium taxes and other fees. (The Montana Insurance Department percentage is about 3 percent.) Although these taxes and fees are paid directly by the companies, the taxes serve to increase the cost of insurance protection and are paid indirectly by the insurance consumer. Printed at the bottom of Insurance Department stationery is the following: "The insurance and investment departments were created for the protection of the citizens of Montana. Use them!" Currently, Montana citizens may not be using the Insurance Department to its fullest extent. Through complaint statistics and the candid admissions of insurance agents, we learned that consumers are overwhelmed by the complexity of present day insurance and little understand the product they are spending millions of dollars on per year.

In an article entitled "Life Insurance: Deceptive Sales Practices," Joseph M. Belth characterized the life insurance market with three words: ignorance, complexity, and apathy.

--Ignorance because most prospective buyers do not understand the different kinds of life insurance policies. They don't know that there are very large differences in price among companies for essentially the same coverage and that many, if not most, life insurance agents are ill-equipped to provide reliable financial advice for their customers.

--Complexity because the complicated nature of insurance reinforces ignorance. Additional complexity stems from the proliferation of policy types. (The Montana Department approved 7,355 new life and disability forms in one year.) "There is virtually an infinite variety of policy types, because many companies engage in product differentiation in an attempt to avoid price competition. Many policies are designed to fit an elaborate sales presentation rather than to perform real services for buyers."

--Apathy on the part of buyers because the typical person does not like to talk about life insurance because it forces him to think about his own death. When people are not interested in finding out how life insurance works, they perpetuate their ignorance.

Of the above three areas that characterize the insurance market, little can be done about apathy. But the overcoming of ignorance and complexity should be one goal of the regulation of insurance.

Consumerism in insurance is not new. Many states and agencies, like the Federal Trade Commission, are breaking down barriers to consumer understanding of insurance through more definitive legislation and greater emphasis on consumer education. Following is a discussion of consumer protection rules and techniques, some of which have been implemented in other states.

CONTACT WITH THE DEPARTMENT

To adequately protect the interests of state residents, an insurance department must make itself accessible to them by providing information and help through a timely and easy means of communication. The Montana Insurance Department does not accept

long distance collect calls from within the state. Therefore, citizens must pay long distance charges to speak directly with the department. Nonacceptance of collect calls may have an inhibitory effect on the consumer seeking information or initiating a complaint. Considering the importance of insurance and the amount of money involved in the insurance industry in Montana, a statewide toll-free line* (13 presently in use by other state agencies) for consumer help and information would be of little consequence financially when compared to the increased ability of Montanans to better use the protection provided by the department.

In April 1978 the department held hearings concerning a new requirement for life insurers to supply the prospective customer a copy of a Life Insurance Buyer's Guide. If initiated, this guide will hopefully improve the buyer's ability to select the appropriate insurance policy for his needs. In addition to the buyer's guide, the reluctance of residents to become involved with state agencies such as the Insurance Department could be reduced and consumer understanding of the services provided could be greatly increased if, with each policy sold in the state, consumers were given the department's phone number, services rendered, and the consumer's rights under the law.

FULL DISCLOSURE

In his article on deceptive sales practices in life insurance, Joseph Belth states, "The deceptive sales practices found

*A toll-free line has been budgeted for and requested by the department.

in the life insurance market constitute a national scandal. What is needed to give the consumer a fighting chance in the life insurance market is a mandated system of information disclosure." Pennsylvania has acknowledged in its present statutes the importance of timing in the proper disclosure of life insurance provisions. A written disclosure statement listing all costs and provisions of the actual policy being sold must be given no later than the time that the application form is signed by the applicant.

Presently in Montana an agent can give the consumer very little information about the actual policy. The application is filled out and a month later the policy comes in the mail or is delivered by the agent. The customer usually accepts on faith that the policy delivered contains the same provisions as the initial proposal, if one was presented.

Many life insurance buyers are overcharged, in the sense that they could buy comparable coverage at a much lower price. The main cause of this problem is that reliable price information is not readily available in the life insurance market. Many sales presentations involve little, if any, such information. Often the presentation is based primarily on emotional considerations and generally the only price information that enters into the presentation is the size of the premium.¹ An FTC study indicated that among whole life policies with the lowest premiums,

¹ Joseph Belth, "Life Insurance: Deceptive Sales Practices," Business and Society Review, 1975, p. 40.

21 percent of those were actually the most expensive policies when ranked by three recognized comparison index methods.

Point-of-sale disclosure statutes effectively place all companies on an equal scale for ease of price comparison and greater consumer understanding. Montana should also consider standard full disclosure requirements. The department has now adopted life insurance proposal requirements which will become effective in December 1978.

POLICY REPLACEMENT

Life insurance policy replacement has been a source of problems for consumers and the insurance industry for many years. The replacement of one policy for another is not unlawful, but many times twisting is involved, (where the agent's motive is to induce an insured to change policies through unfair or exaggerated comparisons between an existing policy and a new one). In very few situations is it in the policyholder's best interest to replace an existing policy (especially one "whole life" for another "whole life"). Valuable benefits are lost and usually the only one that gains is the agent. The Montana Insurance Department presently has a rule that requires that a copy of the replacement proposal be given to the consumer and the other copy be retained by the agent or company for 3 years. Although the department has the authority to determine if this 3-year retention rule is being obeyed, the department does not enforce the requirement. The department has no idea how much or little policy replacement is occurring in the state. If a third copy of

all policy replacement comparison sheets were required to be sent to the department, the policing effect would limit policy replacement and encourage fair comparisons in those policy replacements that do occur.

AGENT TRUST ACCOUNTS

Insurance agents in Montana are not required by statute to maintain fiduciary or trust accounts for the money (usually insurance premiums) they receive in the course of their business. In the department's complaint files we found examples where agents have supposedly misappropriated premium dollars entrusted to them by consumers. In some cases, the money has been commingled in personal bank accounts and never delivered to the company as required. In other instances, applications were written, money was paid, but policies were never delivered. The department corrected these problems when the problems were brought to the department by consumers. Montana real estate agents are required by law to have separate trust accounts. If insurance agents were required to have trust accounts, the temptation to misappropriate funds would be lessened.

HEALTH SERVICE CORPORATIONS

In 1975 the Insurance Department was charged with the responsibility to regulate health service corporations. Health service corporations are nonprofit corporations which are organized to operate plans under which prepaid hospital care, medical-surgical care and other health care and services are furnished to its members. Health service corporations do not consider themselves

insurance companies although they are regulated by the "insurance" code and fall into a definition of insurance given by Webster--"coverage by contract whereby one party undertakes to indemnify or guarantee another against loss by a specified contingency or peril."

Health service corporations are not subject to the same rules by which other insurers must abide for the protection of the public. Some of these differences are noted below. Forms may be used for up to 30 days by health service corporations before being approved by the department. Other insurers must have prior approval of their forms. The salesmen for health service corporations are called "enrollment representatives" and are not required to be examined as are regular insurance agents. The commissioner does reserve the right to subject "enrollment representatives" to an examination and this is presently being done. Because health service corporations are considered nonprofit, they are not subject to the state insurance premium tax as are other companies. Insurance companies must submit to rigid annual financial reporting requirements established by NAIC. Presently, the annual statements filed by health service corporations contain a minimum of financial disclosure information.

Through complaint totals supplied by the department, the health service corporations have had a significant increase in the percentage of valid complaints when compared to regular insurance companies. For example, between 1976 and 1977, the number of complaints against health service corporations increased over 80 percent. During the same period of time the number of

valid complaints against regular insurance companies increased approximately 7 percent. In a random sample of the complaint files, we found that several complaints against health service corporations were due to consumer misunderstanding of the coverage provided. More adequate benefit disclosure may be necessary as in other types of insurance. In any case, under the present regulation of health service corporations, the Montana consumer might be better served if health service corporations were required to comply, as do regular insurers, with the following:

--Prior approval of forms.

--More complete financial disclosure in annual statements.

TITLE INSURANCE REGULATION

The department also licenses and regulates the sellers of title insurance in Montana. While title insurance accounts for a relatively minor amount of the insurance sold in Montana, we did review regulations of the title insurance industry due to information noted in a related sunset performance review.¹

During the conduct of the related review, we identified one Montana title insurance agency which is predominately owned by real estate firms. This situation may be inherently conflicting in that when a buyer must purchase title insurance, the purchase is often coordinated by the real estate agent.

In California the Commissioner of Insurance responded to a similar situation by issuing a bulletin in 1974 which prohibits the payment of title insurance commissions to any individual who

¹ Sunset performance review of the Board of Abstracters, 1978.

is a real estate agent. The commissioner also denied a license to a title insurer organized by real estate agents. In Missouri, the Attorney General brought an anti-trust action against a title insurer which was owned by real estate agents. In 1977 the Michigan Department of Insurance identified 24 title insurers owned by real estate agents. (Full or partial ownership.) The Michigan Department studied the situation and concluded that real estate agent ownership of title insurers diminishes competition. Michigan now prohibits real estate agent ownership of title insurers. The Montana department should also review ownership of title insurers to determine if similar conflicts exist in Montana.

DEPARTMENTAL STAFFING

The staffing of an insurance department directly influences the regulatory ability of the department. The administrative staff of a department plays an integral role in the administration of state laws and must have the ability to oppose the best talent the insurance industry can hire in disputes on rate filings, policy forms, trade practices, and financial activities. In 1959 a U.S. Senate sub-committee on the insurance industry stated: "The technical skills and quality of departmental staff are a key link in the armor of the department for protecting the public interest." The committee also stated: "Self-improvement through on-the-job training and participation in research is necessary for the proper intellectual development of a truly professional staff."

The Montana insurance department does not have a formal training program for its employees. Employees are encouraged to

participate in additional insurance training but they must pay their own way on their own time. In the regulation of an industry as dynamic and ever-changing as the insurance industry, it is difficult to imagine a staff's ability to "keep up" without the existence of some type of formal training program.

In response to the lack of a training program, the chief deputy explained that it was the department's policy to hire already trained and qualified people to staff the Insurance Department. The personnel files were reviewed to determine completeness and to evaluate staff experience and education. With very few exceptions, the education and experience of the staff of the department was unrecorded and unknown. Most files did not even contain job applications.

Presently, the department's attorney can only devote about 60 percent of his time to the Insurance Department. The attorney's duties include responsibilities to the Investment Department and the State Auditor's Office as well. The following are a few examples we earlier discussed where an attorney could have been involved but was not due to time constraints:

- Agent examinations with questions that are statutorily incorrect.
- Conflict between the Insurance Code and Administrative Rules, i.e., temporary agent licensing time criteria.
- Misinterpretation of the insurance code by department staff.

The Insurance Code also authorizes the hiring of an actuary by the department. Actuaries are the "technicians of insurance" and based upon their work, rates, premiums, cash values, and

dividends are determined. The department uses an actuarial consulting service if a rate increase or decrease appears questionable. No staff member is presently qualified to understand and effectively deal with the statistical analysis required in the determination of whether a rate is appropriate. Only the most extreme rate changes are presently questioned by the department.

In previous chapters, the importance of examining companies for solvency was stressed. The Insurance Department has five field examiners whose primary duty is to independently verify the accuracy of insurer's financial statements and determine whether companies are financially sound enough to meet present and anticipated claims of policyholders. Montana's five field examiners are not state employees. The examiners are paid per diem wages, travel expenses, and living allowances directly by the companies being examined. Contract examiners receive no state salary and do not participate in the state retirement system or other employee benefits.

Section 40-2717, R.C.M. 1947, requires insurers to bear the costs of examinations but does not specify the method of payment. Subsection (2) states:

"The commissioner shall pay to the state treasurer to the credit of the general fund all moneys received pursuant to subsection (1) above." (Subsection (1) requires insurers to pay examinations costs.)

Because the field examiners are paid directly by the insurers, no money is collected by the state for the field examiner's services. Over half the states have now limited the possibility

of a conflict of interest by making examiners employees of the state. The states bill the companies directly and thereby increase the independence of their examination staff. The department stated that the legislature has failed to provide "start-up" funds for the revolving fund from which examiners would be paid. In addition, the department does not believe a conflict of interest could be totally avoided by employing examiners directly by the state.

SUMMARY

This chapter has addressed the question: Are all facets of the regulatory process designed solely for the purpose of, and have as their primary effect, the protection of the public?

The saying of "let the buyer beware" may have been appropriate for commerce 100 years ago but it can no longer be applied today. Just as the Federal Drug Administration protects consumers through adequate control of a complex drug industry, so must the individual states protect consumers through the adequate control of an equally complex insurance industry.

As earlier discussed, there are a number of innovative laws and rules that have been implemented throughout the country which are expressly designed to help the consumer cope with a complicated industry whose product, he has been convinced, he cannot live without. These laws and rules include methods for consumer contact and education, full disclosure laws, and more stringent rules regarding policy replacement and agent accounting for trust funds. In addition, laws may be needed for the regulation of

health service companies and title insurers. Implementation of similar laws in Montana would provide an addition to the public protection facet of the regulatory process.

In addition, we noted that there is no formal training program for department staff. Without continuous research and training, which the regulation of insurance demands, the adequacy of the protection provided is questionable. We also noted instances where the services of a full-time attorney and actuary are needed. In other words, certain facets of the regulatory process could be designed for additional protection of the public.

Chapter V

COST CONSIDERATIONS

This chapter addresses the fourth and fifth questions posed in the sunset law: Does regulation have the effect of directly or indirectly increasing the cost of goods or services? Is the increase in cost more harmful to the public than the harm which could result from the absence of regulation?

REGULATION COSTS

What are the costs of regulation earlier mentioned? Costs of regulation are included in the monetary amount paid for goods or services, as well as the actual cost to administer the regulatory program. Regulation costs also include nonmonetary items such as the delivery and timeliness of goods or services--even the availability or absence of goods or services.

The American Insurance Association responded to the sunset question in correspondence with the Legislative Auditor. With regard to the cost of regulation, the association stated:

"Without doubt regulation, like taxation, is reflected in the cost of insurance protection sold to the public. Only part of that cost is reflected in such things as premium taxes, licensing fees, and examination expenses. For every dollar expended directly in such costs at least a matching dollar and perhaps two or three is spent in responding to state regulatory laws, rules, orders, and other regulatory requirements. Ultimately the public must pay these costs in the price they are charged for coverage."¹

We noted in Chapter II (Illustration 2-2) that insurance companies pay a significant amount of money to the department in

¹ William L. Martin, Senior Vice-President and General Counsel, American Insurance Association, New York, correspondence with the Office of the Legislative Auditor, March 8, 1978.

the form of premium taxes. These taxes are based upon a percentage of the premiums the Montana consumer pays to the company for insurance coverage. During fiscal year 1977-78, insurance companies will pay almost \$12 million in premium taxes. These taxes are ultimately paid by the consumer. If the premium tax rate would increase, the premiums charged to the consumer would eventually increase.

As noted by the American Insurance Association, insurance companies must spend considerable time and expense complying with state laws. In addition, the department must spend money administering the regulatory program. We discussed in Chapters III and IV the many regulations with which companies must comply. Company expenditures to comply with laws, rules, and regulations are also passed to the consumer; and the department's expenditures are also ultimately paid by the consumer.

It would be difficult to quantify the actual increase in consumer costs due to regulation. However, we can conclude that regulation causes an increase in prices of insurance to the consumer.

EFFECTS OF DEREGULATION

If regulation increases costs to the consumer, the important question becomes: Is the increase in costs more harmful than the harm which could result in the absence of regulation?

We concluded in Chapter III that the absence of regulation would harm the public. Companies would not be regulated and the consumer would have no assurance that the company had adequate reserves to pay claims. In the event the company became insolvent,

the consumer's premium dollars would be lost. Insurance, by nature, is speculative in that the consumer is protecting himself from an occurrence he cannot accurately predict. To deregulate the industry would force the consumer to speculate on the occurrence and also to speculate on whether or not the company would have funds to cover the occurrence.

Another significant effect of deregulation would probably be the greater frequency of company insolvency. One insolvency could result in the loss of millions of consumer dollars due to the loss of premiums and lack of funds to cover consumer claims.

It is impossible to quantify the cost to the consumer if the insurance industry were deregulated. All states presently regulate the insurance industry in similar fashion. We have evidence that indicates the consumer was harmed prior to state regulation of insurance (see Chapter II). Based upon the above information, we can conclude that the absence of regulation would harm the public by increasing costs. We can also project that the eventual social and economic costs associated with deregulation would be far in excess of the present costs of regulation.

Chapter VI

LESS RESTRICTIVE REGULATION ALTERNATIVES

A sixth and final question posed by the sunset law requires the evaluation of alternative forms of regulation. Specifically it asks: Is there another less restrictive method of regulation available which could adequately protect the public?

ALTERNATIVE REGULATION APPROACHES

In determining the appropriate regulation of the insurance industry there are three major decisions which must be made. These decisions relate to: 1) the proper form of regulation, 2) the regulatory entity that is required under a particular form, and 3) the type and extent of regulatory requirements placed upon the industry in each case.

Following is a brief discussion of the three major decisions. The decision process is then summarized in check-list format. A more detailed discussion of alternative regulation approaches has been prepared as a supplement to this and other sunset audit reports.¹

THE PROPER FORM OF REGULATION

In relation to the first decision, there are a number of alternative forms of regulation ranging from the most extreme form--licensing similar to the present system--to the least extreme--no licensing or regulation whatsoever. Following is a discussion of seven forms of regulation. They are licensing,

¹ "Alternative Methods of Regulating Professions, Occupations, and Industries"--A Supplement to the Sunset Performance Audits," Office of the Legislative Auditor, 1978.

practice restriction, reserve of title, limited statutory regulation, registration, certification, and no regulation.

Licensing involves the stipulation of requirements and prerequisites and the granting of the right or permission to carry on a business or profession. Licensing necessitates an administrative body that establishes rules and monitors the profession or occupation on an ongoing basis. Licensing is considered to be the most extreme form of regulation.

Restriction of practice is the next lesser form of regulation. Under a practice law form of regulation, individuals or companies would not be permitted to perform a specific service or act, or hold themselves out as being able to perform such services, unless they have met certain statutory requirements.

Reserve of title is less restrictive than restriction of practice. Under reserve of title regulation, anyone who desires could engage in the profession or occupation. Only the titles "licensed" or "certified," etc., would be reserved for those who had met certain requirements such as an examination.

Limited statutory regulation can be considered even a lesser degree of state regulation than the previous forms. The state would regulate the industry only through statutes specifying certain limitations. Limited statutory regulation differs from a practice law in that there are no statutory requirements that are "job or ability related" (i.e., examination requirement). The law would require only "after-the-fact" protective measures (i.e., bonding and insurance).

Registration, the next alternative, would afford the opportunity to persons practicing in the profession or industry to register with the state or with a private trade or professional association. An individual or company applicant would not have to demonstrate competency or prove qualification, but would just register his name or the company's name.

Certification, as we define it, is individual oriented and requires no direct involvement by a state governmental body. The insurance industry would be responsible for certification requirements and procedures, and would be self-regulating. Certification would provide for public identification of those individuals designated by the industry as certified, but the industry could not limit the practice of insurance to only those certified.

The least extreme form of regulation is no regulation. The public would still have protection and recourse through the Consumer Affairs Division of the Department of Business Regulation under the Unfair Trade Practices Act (Chapter 275, Laws of Montana, 1973), which protects the consumer from fraud and deception. Criminal and civil remedies can also be sought under the Uniform Commercial Code and other laws directed at specific abuses. It is important to again note that the laws on consumer protection are in effect at the present time and would be in effect under all of the alternatives discussed.

THE REGULATORY ENTITY

Regulatory entities can take many forms depending upon the degree of state regulation needed. We have identified six regulatory entities: professional state board, professional-public

state board, public state board, state department/agency, professional association, and state/local agency (indirect involvement).

The traditional form of regulation of professions and industries is accomplished by professional boards. These boards are made up entirely of members of the profession or industry. Boards can also be made up of a combination of profession members and of members from the public. A board could also consist entirely of members from the public.

Regulation could be accomplished through the direct involvement of a state department or agency. If no direct regulation by the state is necessary, then a professional association could regulate its membership. In addition, indirect involvement by a state agency is available if direct state regulation is not necessary. For example, the Consumer Affairs Division could investigate and resolve consumer complaints against any industry or occupation even if that industry or occupation were not directly regulated by the state.

TYPES OF REGULATORY REQUIREMENTS

If some form of regulation is determined to be appropriate for the insurance industry, then certain requirements and conditions for licensure must also be established.

Education, experience, and examination requirements, as conditions for licensure, could be established by statute and administered by the regulatory body. Means of financial protection for the public and licensees could be required in the form of bonding, recovery funds, errors and omissions insurance, etc..

The regulatory body, through its administrative branch, may collect fees such as those for examinations and licenses, and issue a document to insurance companies and to individuals (license) following successful compliance with such prerequisites. The regulating body could have the authority to promulgate rules and adopt codes of conduct. It could deny, suspend, or revoke licenses based upon noncompliance, violations, or incompetence. The regulatory body could also have investigative and monitoring functions.

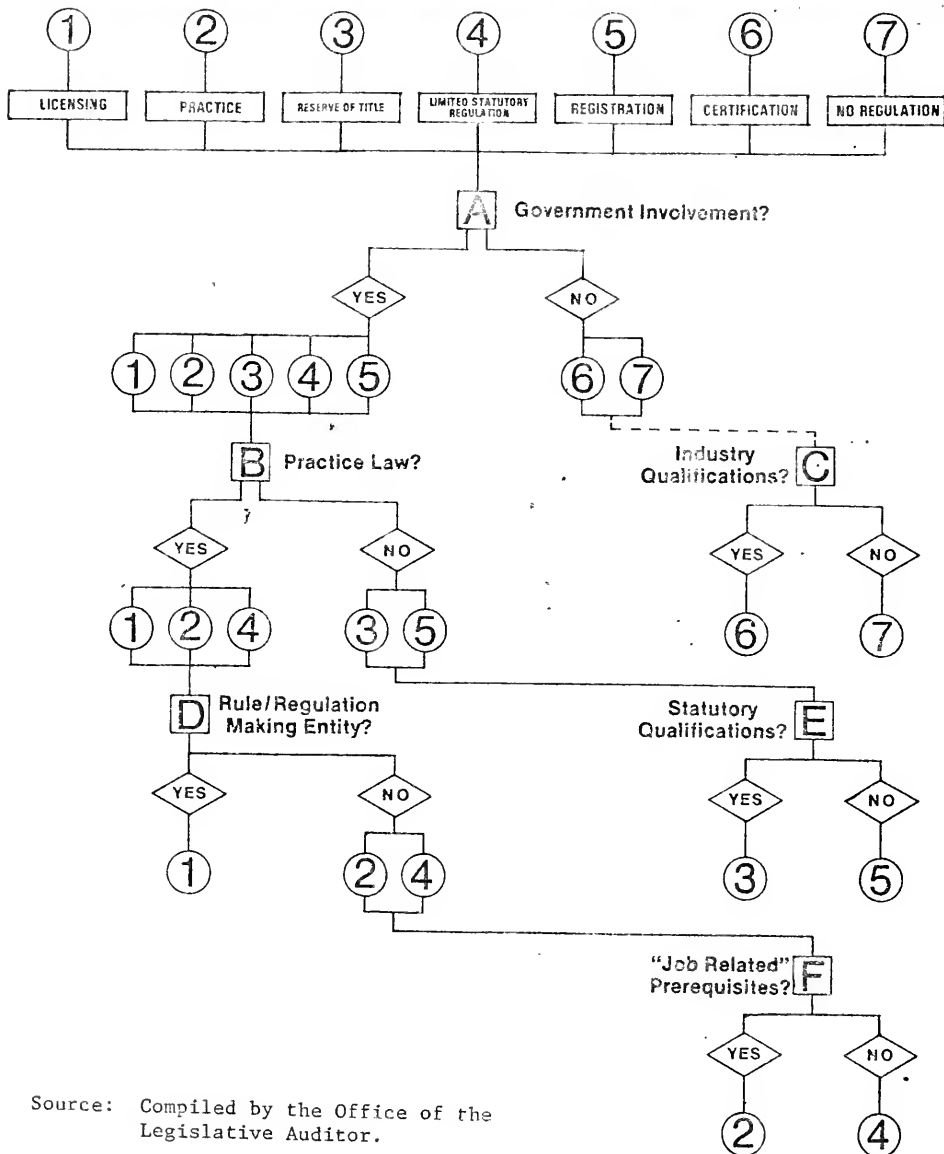
Periodic renewal of licenses could be a requirement. This renewal can be a mere payment of a fee, as is the present situation, or renewal could depend upon the applicant meeting certain qualification standards. Thus, licensees could be required to maintain proficiency through continuing education, passage of a periodic examination, or peer review.

SUMMARY

The decision as to the extent to which the state needs to be involved in regulation of a profession or industry requires the analysis of many factors. We have briefly discussed these factors in this chapter.

These factors are presented in decision chart format in the following Illustrations 6-1, 6-2, and 6-3. A more detailed discussion of the alternative methods of regulation appears in a supplement to this report.

DECISION CHART TO DETERMINE THE FORM OF REGULATION



Source: Compiled by the Office of the
Legislative Auditor.

Illustration 6-1

ALTERNATIVE REGULATORY BODY UNDER EACH FORM OF REGULATION

	LICENSING	PRACTICE	RESERVE OF TITLE	LIMITED STATUTORY REGULATION	REGISTRATION	CERTIFICATION	NO REGULATION
PROFESSIONAL STATE BOARD ► Multi-member; or ► Commissioner	<input type="radio"/>						
PROFESSIONAL PUBLIC STATE BOARD ► Multi-member	<input type="radio"/>						
PUBLIC STATE BOARD ► Multi-member; or ► Commissioner	<input type="radio"/>						
STATE DEPARTMENT/AGENCY ► Direct involvement	<input checked="" type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>		
PROFESSIONAL ASSOCIATION ► Industry involvement					<input type="radio"/>	<input type="radio"/>	
STATE/LOCAL AGENCY ► Indirect involvement ► Civil/Criminal Sanctions	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

■ Indicates present form of regulation

Source: Compiled by the Office of the Legislative Auditor.

Illustration 6-2

ALTERNATIVE REQUIREMENTS UNDER EACH FORM OF REGULATION

	LICENSING	PRACTICE	RESERVE OF TITLE	LIMITED STATUTORY REGULATION	REGISTRATION	*CERTIFICATION	NO REGULATION	PRESENT FORM
1. Rule/Regulation Making Entity :	●					●		●
2. Educational Requirements	●	●	●			●		●
3. Experience Requirements	●	●	●			●		●
4. Examination	●	●	●			●		●
5. Right of Denial	●	●	●	●		●		●
6. Revocation/Suspension	●					●		●
7. Issuance of a Document	●				●	●		●
8. Investigation/Enforcement	●					●		●
9. Periodic Renewal	●				●	●		●
10. Continuing Education	●					●		
11. Retesting	●					●		
12. Reciprocity/Comity	●	●	●	●	●	●		●
13. Bonding	●	●	●	●		●		
14. Recovery Fund	●					●		
15. Errors and Omissions Insurance	●	●	●	●		●		
16. Fees	●	●	●		●	●		●
17. Individual Oriented	●	●	●	●	●	●	●	●
18. Facility Oriented	●		●	●	●	●	●	
19. Peer Review	●	●	●			●		

*Determined by industry body

Source: Compiled by the Office of the Legislative Auditor.

Illustration 6-3

